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Tax Advantages of Incurring Losses in Sale of Rental Property

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If you need to sell your rental property and you might incur losses, this could be good news. In fact, you might be able to deduct the losses against any types of income, of course, with some caveats. Let's see how.

To start, this could be useful to review some basics:

1. MAKE SURE YOU HAVE A LOSS

The most important step is to know if you really have a loss after a rental property sale. You might calculate that you bought the property at X amount and now it is less. So, you must have a loss. Unfortunately, this calculation is inaccurate.

A. How to Calculate Your Tax Basis in a Rental Property

Tax basis of your rental property is calculated based on the price you originally paid PLUS the costs of improvements over the years (not the repairs you took tax deductions for along the way) MINUS all depreciation write-offs you claimed during your ownership.

As such, your sale might trigger a tax gain not a tax loss. So, keep this mind.

B. 1031 Exchange Might Lower or Dissipate Your Loss

This is important to note if you obtained your rental property in a 1031 exchange, your tax basis might be a lot lower than what you might think. This could be the case when your initial tax basis in a property was reduced by the amount of property you deferred in a 1031 exchange.So, you deferred a large gain, your basis reduction was a large number. Therefore, the sale of the rental property might trigger a tax gain and not a tax loss.

EXAMPLE

For instance, you initially purchased a rental property for $500,000. Then, in a 1031 exchange, you swapped that one with a property for $900,000. You took $100,000 of depreciation deductions over the years. You sell the property for $750,000. Now, your tax basis upon sale of the rental property equals $900,000 (the Purchase Price of the Second Property)-$100,000 (Depreciation Deductions)=$800,000. So, the difference between your tax basis of $800,000 and what you sold $750,000 is $50,000 of tax gain.

2. SECTION 1231 LOSS: BINGO

If you have a tax loss on a property you have owned for more than one year, that is section 1231 loss. This is one of the best kinds of losses because you can deduct it against any type of income i.e. salary, interest, dividend, capital gains, alimony received, self-employment income and whatever.

3. PASSIVE LOSSES UPON SALE

As you remember, rental property passive losses are hard to deduct; however, upon sale you could deduct such losses. Such losses could be characterized as Net Operating Losses and if your 1231 tax losses are large enough, you could carry back to prior years or forward to future years.

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